PROSPERITY BANCSHARES INC
Form 10-Q
November 09, 2007
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 000-25051

# PROSPERITY BANCSHARES, INC.®

**(Exact name of registrant as specified in its charter)**

| **TEXAS** | **74-2331986** |
| --- | --- |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**Prosperity Bank Plaza**

**4295 San Felipe**

**Houston, Texas 77027**

**(Address of principal executive offices, including zip code)**

**(713) 693-9300**

**(Registrant s telephone number, including area code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer: x Accelerated filer: ¨ Non-accelerated filer: ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of November 1, 2007, there were 44,126,196 shares of the registrant s Common Stock, par value $1.00 per share, outstanding.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

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**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**PROSPERITY BANCSHARES, INC®. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(UNAUDITED)**

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| | (Dollars in thousands, except share data) | |
| ASSETS | | |
| Cash and due from banks | $ 141,662 | $ 116,078 |
| Federal funds sold | 100,876 | 153,643 |
| Total cash and cash equivalents | 242,538 | 269,721 |
| Interest bearing deposits in financial institutions | 297 | 397 |
| Available for sale securities, at fair value (amortized cost of $363,214 and $438,869, respectively) | 360,290 | 434,331 |
| Held to maturity securities, at cost (fair value of $1,433,400 and $1,131,096, respectively) | 1,444,036 | 1,155,972 |
| Loans held for investment | 3,109,868 | 2,176,507 |
| Loans held for sale | 17,687 | |
| Less allowance for credit losses | (35,536) | (23,990) |
| Loans, net | 3,092,019 | 2,152,517 |
| Accrued interest receivable | 28,866 | 20,364 |
| Goodwill | 745,650 | 424,339 |
| Core deposit intangibles, net of accumulated amortization of $18,870 and $11,573, respectively | 48,689 | 23,032 |
| Bank premises and equipment, net | 120,794 | 63,057 |
| Other real estate owned | 1,460 | 140 |
| Bank Owned Life Insurance (BOLI) | 45,015 | 14,176 |
| Leased assets | 3,818 | 3,709 |
| Other assets | 37,052 | 25,014 |
| TOTAL ASSETS | $ 6,170,524 | $ 4,586,769 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest-bearing | $ 1,165,089 | $ 835,876 |
| Interest-bearing | 3,618,925 | 2,889,802 |
| Total deposits | 4,784,014 | 3,725,678 |
| Other borrowings | 31,988 | 26,408 |
| Securities sold under repurchase agreements | 79,484 | 47,225 |
| Accrued interest payable | 13,276 | 8,451 |
| Other liabilities | 37,632 | 14,077 |
| Junior subordinated debentures | 112,885 | 100,519 |
| Total liabilities | 5,059,279 | 3,922,358 |

| | | |
|---|---|---|
| COMMITMENTS AND CONTINGENCIES | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock, $1 par value; 20,000,000 shares authorized; none issued or outstanding | | |
| Common stock, $1 par value; 200,000,000 shares authorized; 44,147,196 and 32,829,873 shares issued at September 30, 2007 and December 31, 2006, respectively; 44,110,108 and 32,792,785 shares outstanding at September 30, 2007 and December 31, 2006, respectively | 44,147 | 32,830 |
| Capital surplus | 807,760 | 425,557 |
| Retained earnings | 261,846 | 209,581 |
| Accumulated other comprehensive loss net unrealized loss on available for sale securities, net of tax benefit of $1,023 and $1,588, respectively | (1,901) | (2,950) |
| Less treasury stock, at cost, 37,088 shares | (607) | (607) |
| Total shareholders equity | 1,111,245 | 664,411 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | $ 6,170,524 | $ 4,586,769 |

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**(UNAUDITED)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands, except per share data) | | | |
| INTEREST INCOME: | | | | |
| Loans, including fees | $ 64,036 | $ 43,625 | $ 185,919 | $ 113,685 |
| Securities: | | | | |
| Taxable | 22,116 | 17,532 | 63,596 | 52,597 |
| Nontaxable | 946 | 513 | 2,665 | 1,337 |
| 70% nontaxable preferred dividends | 254 | 257 | 760 | 664 |
| Federal funds sold | 648 | 220 | 2,216 | 554 |
| Deposits in financial institutions | 4 | 3 | 12 | 9 |
| Total interest income | 88,004 | 62,150 | 255,168 | 168,846 |
| INTEREST EXPENSE: | | | | |
| Deposits | 31,794 | 22,519 | 92,328 | 57,487 |
| Junior subordinated debentures | 2,358 | 2,106 | 7,852 | 5,497 |
| Federal funds purchased and other borrowings | 1,548 | 1,061 | 3,867 | 2,831 |
| Securities sold under repurchase agreements | 935 | 497 | 2,319 | 1,292 |
| Total interest expense | 36,635 | 26,183 | 106,366 | 67,107 |
| NET INTEREST INCOME | 51,369 | 35,967 | 148,802 | 101,739 |
| PROVISION FOR CREDIT LOSSES | 75 | 120 | 640 | 360 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 51,294 | 35,847 | 148,162 | 101,379 |
| NONINTEREST INCOME: | | | | |
| Customer service fees | 10,785 | 7,079 | 29,908 | 20,610 |
| Other | 3,374 | 1,839 | 9,767 | 5,131 |
| Total noninterest income | 14,159 | 8,918 | 39,675 | 25,741 |
| NONINTEREST EXPENSE: | | | | |
| Salaries and employee benefits | 16,365 | 10,268 | 48,163 | 31,195 |
| Net occupancy expense | 2,665 | 2,166 | 7,759 | 5,814 |
| Data processing | 1,290 | 928 | 3,447 | 2,728 |
| Core deposit intangible amortization | 2,586 | 1,191 | 7,297 | 3,616 |
| Depreciation expense | 1,895 | 1,265 | 5,656 | 3,767 |
| Other | 5,286 | 4,011 | 15,108 | 11,357 |
| Total noninterest expense | 30,087 | 19,829 | 87,430 | 58,477 |

| | | | | |
|---|---|---|---|---|
| INCOME BEFORE INCOME TAXES | 35,366 | 24,936 | 100,407 | 68,643 |
| PROVISION FOR INCOME TAXES | 11,518 | 8,572 | 33,336 | 23,520 |
| NET INCOME | $ 23,848 | $ 16,364 | $ 67,071 | $ 45,123 |
| EARNINGS PER SHARE | | | | |
| Basic | $ 0.54 | $ 0.50 | $ 1.58 | $ 1.45 |
| Diluted | $ 0.54 | $ 0.49 | $ 1.56 | $ 1.43 |

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

**(UNAUDITED)**

| | Common Stock | | | | Accumulated | | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Capital Surplus | Retained Earnings | Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders Equity |
| | (Dollars in thousands, except share data) | | | | | | |
| BALANCE AT JANUARY 1, 2006 | 27,857,887 | $ 27,858 | $ 280,525 | $ 160,883 | $ (3,942) | $ (607) | $ 464,717 |
| Comprehensive Income: | | | | | | | |
| Net income | | | | 61,725 | | | 61,725 |
| Net change in unrealized gain (loss) on available for sale securities. | | | | | 992 | | 992 |
| Total comprehensive income | | | | | | | 62,717 |
| Common stock issued in connection with the exercise of stock options and restricted stock awards | 523,761 | 524 | 7,268 | | | | 7,792 |
| Common stock issued in connection with the SNB Bancshares acquisition | 4,448,225 | 4,448 | 136,914 | | | | 141,362 |
| Stock based compensation expense | | | 850 | | | | 850 |
| Cash dividends declared, $0.41 per share | | | | (13,027) | | | (13,027) |
| BALANCE AT DECEMBER 31, 2006 | 32,829,873 | 32,830 | 425,557 | 209,581 | (2,950) | (607) | 664,411 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 67,071 | | | 67,071 |
| Net change in unrealized gain (loss) on available for sale securities | | | | | 1,049 | | 1,049 |
| Total comprehensive income | | | | | | | 68,120 |
| Common stock issued in connection with the exercise of stock options and restricted stock awards | 296,021 | 296 | 2,359 | | | | 2,655 |
| Common stock issued in connection with the Texas United Bancshares acquisition | 10,769,942 | 10,770 | 370,116 | | | | 380,886 |
| Common stock issued in connection with The Bank of Navasota acquisition | 251,360 | 251 | 8,237 | | | | 8,488 |
| Stock based compensation expense | | | 1,491 | | | | 1,491 |
| Cash dividends declared, $0.3375 per share | | | | (14,806) | | | (14,806) |
| BALANCE AT SEPTEMBER 30, 2007 | 44,147,196 | $ 44,147 | $ 807,760 | $ 261,846 | $ (1,901) | $ (607) | $ 1,111,245 |

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(UNAUDITED)**

| | Nine Months Ended September 30, 2007 | 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 67,071 | $ 45,123 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 12,953 | 7,383 |
| Provision for credit losses | 640 | 360 |
| Net (accretion) amortization of discount/premium on investments | (6,120) | (257) |
| Net gain on sale of other real estate | (552) | (37) |
| Net gain on sale of securities | (58) | |
| Net gain on sale of premises, equipment and other assets | (182) | (540) |
| Net gain on held for sale loans | (1,202) | |
| Fundings of held for sale loans | (49,466) | |
| Proceeds from held for sale loans | 155,804 | |
| Stock-based compensation expense | 1,491 | 606 |
| Decrease (increase) in other assets and accrued interest receivable | 13,230 | (1,133) |
| Increase in accrued interest payable and other liabilities | 555 | 7,787 |
| Net cash provided by operating activities | 194,164 | 59,292 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from maturities and principal paydowns of held to maturity securities | 235,867 | 239,372 |
| Purchase of held to maturity securities | (382,154) | (54,662) |
| Proceeds from maturities and principal paydowns of available for sale securities | 819,266 | 46,762 |
| Proceeds from the sales of available for sale securities | 349,224 | |
| Purchase of available for sale securities | (960,992) | (31) |
| Net decrease (increase) in loans | 176,535 | (74,079) |
| Purchase of bank premises and equipment | (5,595) | (3,375) |
| Net decrease (increase) in interest-bearing deposits in financial institutions | 100 | (100) |
| Proceeds from sale of bank premises, equipment, other real estate and other assets | 7,371 | 3,148 |
| Purchase of the Bank of Navasota | (8,751) | |
| Cash and cash equivalents acquired in the purchase of the Bank of Navasota | 19,175 | |
| Purchase of Texas United Bancshares, Inc. | (2,024) | |
| Cash and cash equivalents acquired in the purchase of Texas United Bancshares, Inc. | 114,469 | |
| Purchase of SNB Bancshares, Inc. | | (93,849) |
| Cash and cash equivalents acquired in the purchase of SNB Bancshares, Inc. | | 18,020 |
| Purchase of Grapeland Bancshares, Inc. | | (77) |
| Net cash provided by investing activities | 362,491 | 81,129 |

*(Table continued on following page)*

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| | Nine Months Ended September 30, | |
|---|---|---|
| | 2007 | 2006 |
| | (Dollars in thousands) | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net (decrease) increase in noninterest-bearing deposits | $ (81,218) | $ 5,612 |
| Net decrease in interest-bearing deposits | (251,797) | (76,706) |
| Net repayments of other borrowings | (222,260) | (44,420) |
| Net increase in securities sold under repurchase agreements | 16,063 | 1,474 |
| Redemption of junior subordinated debentures | (32,475) | (6,000) |
| Proceeds from exercise of stock options | 2,655 | 7,773 |
| Payments of cash dividends | (14,806) | (9,338) |
| Net cash used in financing activities | (583,838) | (121,605) |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | $ (27,183) | $ 18,816 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 269,721 | 97,364 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $ 242,538 | $ 116,180 |
| NONCASH ACTIVITIES: | | |
| Stock issued in connection with the acquisition of The Bank of Navasota | $ 251 | $ |
| Stock issued in connection with the acquisition of Texas United Bancshares, Inc. | 383,247 | |
| Stock issued in connection with the acquisition of SNB Bancshares, Inc. | | 141,362 |
| SUPPLEMENTAL DISCLOSURES: | | |
| Cash paid for interest | $ 104,945 | $ 64,090 |
| Cash paid for income taxes | 22,400 | 14,450 |

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**

**(UNAUDITED)**

1. BASIS OF PRESENTATION

The interim consolidated financial statements include the accounts of Prosperity Bancshares, Inc. ®(the Company ) and its wholly-owned subsidiaries, Prosperity Bank ®(the Bank ) and Prosperity Holdings of Delaware, L.L.C. All significant inter-company transactions and balances have been eliminated.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the statements reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company on a consolidated basis, and all such adjustments are of a normal recurring nature. These financial statements and the notes thereto should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2006. Operating results for the nine month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

2. EARNINGS PER SHARE

The following table illustrates the computation of basic and diluted earnings per share:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands, except per share amounts) | | | |
| Net income available to common shareholders | $ 23,848 | $ 16,364 | $ 67,071 | $ 45,123 |
| Weighted average common shares outstanding | 43,910 | 32,771 | 42,521 | 31,053 |
| Potential dilutive common shares | 344 | 411 | 413 | 399 |
| Weighted average common shares and equivalents outstanding | 44,254 | 33,182 | 42,934 | 31,452 |
| Basic earnings per common share | $ 0.54 | $ 0.50 | $ 1.58 | $ 1.45 |
| Diluted earnings per common share | $ 0.54 | $ 0.49 | $ 1.56 | $ 1.43 |

Basic earnings per share is computed by dividing net income by the weighted-average number of shares outstanding during the applicable period. Diluted earnings per share is computed using the weighted-average number of shares determined for the basic computation plus the dilutive effect of stock options and non-vested restricted stock granted using the treasury stock method. There were no stock options exercisable at September 30, 2007 and 2006 that would have had an anti-dilutive effect on the above computation.

3. NEW ACCOUNTING STANDARDS

*SFAS No. 155, Accounting for Certain Hybrid Financial Instruments.* SFAS 155 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS

155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. Adoption of SFAS 155 on January 1, 2007 did not have a significant impact on the Company s financial statements.

**PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**

**(UNAUDITED)**

*SFAS No. 157, Fair Value Measurements.* SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company s financial statements.

*SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115.* SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Company on January 1, 2008. The Company is currently evaluating the effect the adoption of SFAS 159 will have on its financial statements.

**Financial Accounting Standards Board Interpretations**

*FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109.* The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109, effective January 1, 2007. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met, the tax matter is ultimately settled, or the statute of limitations for examination by the appropriate taxing authority expires. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The Company s policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. Penalties are recorded in other (gains) losses and interest paid or received is recorded in interest expense or interest income, respectively, in the statement of income. The Company has identified its federal tax return and its state franchise tax return in Texas as major tax jurisdictions, as defined. The only periods subject to examination for the Company s federal return are the 2003 through 2006 tax years. The Company believes that its income tax filing positions and deductions will more-likely-than-not be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

4. GOODWILL AND CORE DEPOSIT INTANGIBLES

Changes in the carrying amount of the Company s goodwill and core deposit intangibles (CDI) for nine months ended September 30, 2007 were as follows:

| | Goodwill | Core Deposit Intangibles |
|---|---|---|
| | (In thousands) | |
| Balance as of December 31, 2006 | $ 424,339 | $ 23,032 |
| Amortization | | (7,297) |
| Acquisition of Texas United Bancshares, Inc. | 314,342 | 30,995 |
| Acquisition of The Bank of Navasota | 7,055 | 1,959 |

| | | |
|---|---|---|
| Acquisitions prior to December 31, 2006 (deferred taxes) | (86) | |
| Balance as of September 30, 2007 | $ 745,650 | $ 48,689 |

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**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**

**(UNAUDITED)**

Purchase accounting adjustments to prior year acquisitions were made to adjust deferred tax asset and liability balances. Goodwill is recorded on the acquisition date of each entity. The Company may record subsequent adjustments to goodwill for amounts undeterminable at acquisition date, such as deferred taxes and real estate valuations, and therefore the goodwill amounts reflected in the table above may change accordingly. The Company initially records the total premium paid on acquisitions as goodwill. After a third party valuation, core deposit intangibles are identified and reclassified from goodwill to core deposit intangibles on the balance sheet. This reclassification has no effect on total assets, liabilities, shareholders equity, net income or cash flows. Management performs an annual evaluation of whether any impairment of the goodwill and other intangibles has occurred. If any such impairment is determined, a write down is recorded. As of September 30, 2007, there were no impairments recorded on goodwill.

Core deposit intangibles are amortized on an accelerated basis over their estimated lives, which the Company believes is between 8 and 10 years. Gross core deposit intangibles outstanding were $67.6 million and $34.6 million at September 30, 2007 and December 31, 2006, respectively. Net core deposit intangibles outstanding were $48.7 million and $23.0 million at the same dates, respectively. Amortization expense related to intangible assets totaled $2.6 million and $1.2 million for the three months ended September 30, 2007 and 2006, respectively and $7.3 million and $3.6 million for the nine months ended September 30, 2007 and 2006, respectively. Both increases are primarily due to the core deposit intangibles from the TXUI and Bank of Navasota acquisitions. The estimated aggregate future amortization expense for intangible assets remaining as of September 30, 2007 is as follows (dollars in thousands):

| | |
|---|---|
| 2007 | $ 2,620 |
| 2008 | 9,504 |
| 2009 | 8,447 |
| 2010 | 7,403 |
| 2011 | 6,254 |
| Thereafter | 14,461 |
| Total | $ 48,689 |

5. STOCK BASED COMPENSATION

The Company had two stock-based employee compensation plans at September 30, 2007 and five stock option plans assumed in connection with acquisitions under which no additional options will be granted. Prior to 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. The Company adopted SFAS 123 on January 1, 2003 and SFAS 123(R) on January 1, 2006. The Company recognized $1.5 million and $606,000 in stock-based compensation expense for the nine months ended September 30, 2007 and 2006, respectively and $534,000 and $223,000 in stock-based compensation expense for the three months ended September 30, 2007 and 2006, respectively. There was approximately $315,000 and $27,000 of income tax benefit recorded for the stock-based compensation expense for the nine months ended September 30, 2007 and 2006, respectively, and $115,000 and $13,000 of income tax benefit recorded for the stock-based compensation expense for the three months ended September 30, 2007 and 2006, respectively.

The Company has granted shares of common stock subject to forfeitures restrictions ( restricted stock ) to certain directors and associates under the Company s 2004 Stock Incentive Plan. The awardee is not entitled to the delivery of the shares until the forfeiture restrictions lapse, which is generally over a 1 to 5 year period, however the awardee is entitled to receive dividends on and vote the shares prior to the lapse of such restrictions. The shares granted do not have a cost to the awardee and the only requirement of the lapse of the forfeiture restriction is continued service to the Company. Compensation cost related to restricted stock is calculated based on the fair value of the shares at the date of grant. If the awardee leaves the Company before the forfeiture restrictions lapse, the unvested shares are forfeited. As of September 30, 2007, there were 84,306 shares of restricted stock outstanding with a weighted average grant date fair value of $34.83.

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**PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**

**(UNAUDITED)**

Stock options are issued at the current market price on the date of the grant, subject to a pre-determined vesting period with a contractual term of 10 years. Options assumed in connection with acquisitions have contractual terms as established in the original option grant agreements entered into prior to acquisition. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. Stock-based compensation expense is recognized ratably over the requisite service period for all awards.

The fair value of options was estimated using an option-pricing model with the following weighted average assumptions:

| | September 30, 2007 | September 30, 2006 |
|---|---|---|
| Expected life in years | 4.57 | 4.64 |
| Risk free interest rate | 4.20% | 4.18% |
| Volatility | 20.98% | 21.29% |
| Dividend yield | 1.23% | 1.27% |

A summary of changes in outstanding vested and unvested options during the nine months ended September 30, 2007 is set forth below:

| | Number of Options (In thousands) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (In thousands) |
|---|---|---|---|---|
| Options outstanding, beginning of period | 1,142 | $ 21.68 | | |
| Options granted (1) | 230 | 17.51 | | |
| Options forfeited | (21) | 24.57 | | |
| Options exercised | (217) | 12.25 | | |
| Options outstanding, end of period | 1,134 | $ 22.72 | 6.01 | $ 11,846 |
| Options exercisable, end of period | 421 | $ 15.69 | 4.12 | $ 7,362 |

(1) Includes 179,956 options assumed in the acquisition of TXUI at a weighted average exercise price of $13.12.

A total of 50,000 options were granted during the nine months ended September 30, 2007 and 39,000 options were granted during the nine months ended September 30, 2006. The Company assumed 179,956 options in connection with the TXUI acquisition which were fully vested upon consummation of the transaction. The total intrinsic value of the options exercised during the nine month periods ended September 30, 2007 and 2006 was $7.4 million and $9.7 million, respectively. Excluding the options assumed in the TXUI acquisition in 2007, the total fair value of options vested during the nine month periods ended September 30, 2007 and 2006 was $296,000 and $248,000, respectively.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**

**(UNAUDITED)**

A summary of changes in unvested options is set forth below:

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2007 | | 2006 | |
| | Number of Options (In thousands) | Weighted Average Grant Date Fair Value | Number of Options (In thousands) | Weighted Average Grant Date Fair Value |
| Unvested options outstanding, beginning of period | 778 | $ 5.93 | 849 | $ 5.52 |
| Options granted | 50 | 8.39 | 39 | 7.48 |
| Unvested options forfeited | (21) | 5.16 | (20) | 5.44 |
| Options vested | (94) | 3.13 | (85) | 2.90 |
| Unvested options outstanding, end of period | 713 | $ 6.49 | 783 | $ 5.92 |

The Company received $2.7 million and $7.8 million in cash from the exercise of stock options during the nine month periods ended September 30, 2007 and 2006, respectively. The increase in cash received for the exercise of stock options for the nine months ended September 30, 2006 was primarily due to the exercise of options assumed in connection with the SNB acquisition. There was no tax benefit realized from option exercises of the stock-based compensation arrangements during the nine month periods ended September 30, 2007 and 2006.

As of September 30, 2007, there was $3.6 million of total unrecognized compensation expense related to unvested stock-based compensation arrangements. That cost is expected to be recognized over a weighted average period of 2.5 years.

6. RECENT ACQUISITIONS

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas ( TXUI ). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently each of TXUI s wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank, was merged into the Bank. The Company issued approximately 10.8 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the acquisition, the Company assumed $44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-one (41) banking offices in Texas, two of which were subsequently consolidated with existing Prosperity banking centers. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of $1.806 billion, loans (including loans held for sale) of $1.212 billion, deposits of $1.362 billion and shareholders equity of $161.9 million.

As a result of the acquisition of TXUI, the consolidated statements of income and consolidated statements of cash flows for the three months and nine months ended September 30, 2007 include the results of operations and cash flows, respectively, of TXUI beginning February 1, 2007. In addition, the consolidated balance sheet as of September 30, 2007 includes preliminary estimates of the fair values of assets acquired and liabilities assumed as of the acquisition date for TXUI. The Company has not completed its assessment of the fair values of the acquired TXUI assets and liabilities and therefore, the allocation of the purchase price is subject to revision.

**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2007**

**(UNAUDITED)**

The table below summarizes select pro forma data for the two combined companies for the periods indicated, assuming that the transaction was consummated on January 1 of the earliest indicated period:

| | For the nine months ended September 30, | |
|---|---|---|
| | 2007 | 2006 |
| | (In thousands, except per share amounts) | |
| Net interest income | $ 155,052 | $ 166,050 |
| Net income | 68,983 | 63,715 |
| Earnings per share (diluted) | $ 1.56 | $ 1.46 |

On August 31, 2007, the Company completed its acquisition of The Bank of Navasota, N.A., Navasota, Texas through the merger of the Bank of Navasota into the Bank. The Company issued approximately 251,000 shares of its common stock and paid approximately $8.6 million in cash for all of the issued and outstanding capital stock of the Bank of Navasota. The Bank of Navasota operated one banking office in Navasota, Texas, which became a full-service banking center of Prosperity Bank. As of June 30, 2007, the Bank of Navasota had total assets of $73.4 million, loans of $33.0 million, deposits of $63.8 million and shareholders equity of $9.1 million.

7. PENDING ACQUISITION

On October 22, 2007, the Company announced its signing of a definitive agreement by the Bank to purchase the six (6) Houston retail bank branches of Banco Popular North America (BPNA). The Bank will pay a premium of 10.10% on the average deposits of the branches for a 20-day period prior to the closing date and will also purchase certain loans and other assets attributable to the branches. As of September 30, 2007, there were $140 million in deposits in BPNA s Houston branches.

8. REDEMPTION OF JUNIOR SUBORDINATED DEBENTURES

On September 26, 2007, the Company redeemed in full the debentures held by First Capital Statutory Trust II in the amount of $7.7 million. The debentures redeemed bore interest at a floating rate of 3 month LIBOR + 3.40%. The trust in turn redeemed in full the trust preferred securities and common securities it issued.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**Special Cautionary Notice Regarding Forward-Looking Statements**

Statements and financial discussion and analysis contained in this quarterly report on Form 10-Q that are not historical facts are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and are including this statement for purposes of invoking these safe harbor provisions. These forward-looking statements include information about possible or assumed future results of the Company s operations or performance. By using any of the words believe, expect , anticipate , estimate , continue , intend , may , will , should , or similar expressions, the Company i forward-looking statements. Many possible factors or events could affect the future financial results and performance of the Company and could cause those financial results or performance to differ materially from those expressed in the forward-looking statement. These possible events or factors include, without limitation:

changes in interest rates and market prices, which could reduce the Company s net interest margins, asset valuations and expense expectations;

changes in the levels of loan prepayments and the resulting effects on the value of the Company s loan portfolio;

changes in local economic and business conditions which adversely affect the Company s customers and their ability to transact profitable business with the company, including the ability of the Company s borrowers to repay their loans according to their terms or a change in the value of the related collateral;

increased competition for deposits and loans adversely affecting rates and terms;

the timing, impact and other uncertainties of future acquisitions, including the Company s ability to identify suitable future acquisition candidates, the success or failure in the integration of their operations, and the ability to enter new markets successfully and capitalize on growth opportunities;

increased credit risk in the Company s assets and increased operating risk caused by a material change in commercial, consumer and/or real estate loans as a percentage of the total loan portfolio;

the failure of assumptions underlying the establishment of and provisions made to the allowance for credit losses;

changes in the availability of funds resulting in increased costs or reduced liquidity;

increased asset levels and changes in the composition of assets and the resulting impact on the Company s capital levels and regulatory capital ratios;

the Company s ability to acquire, operate and maintain cost effective and efficient systems without incurring unexpectedly difficult or expensive but necessary technological changes;

- the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels;

- changes in statutes and government regulations or their interpretations applicable to financial holding companies and the Company s present and future banking and other subsidiaries, including changes in tax requirements and tax rates;

- acts of terrorism, an outbreak of hostilities or other international or domestic calamities, weather or other acts of God and other matters beyond the Company s control; and

- other risks and uncertainties listed from time to time in the Company s reports and documents filed with the Securities and Exchange Commission.

A forward-looking statement may include a statement of the assumptions or bases underlying the forward-looking statement. The Company believes it has chosen these assumptions or bases in good faith and that they are reasonable. However, the Company cautions you that assumptions or bases almost always vary from actual results, and the differences

between assumptions or bases and actual results can be material. The Company undertakes no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

COMPLETION OF ACQUISITION OF TEXAS UNITED BANCSHARES, INC. AND THE BANK OF NAVASOTA

On January 31, 2007, the Company completed its acquisition of Texas United Bancshares, Inc., La Grange, Texas ( TXUI ). Under the terms of the merger agreement, TXUI was merged into the Company and subsequently each of TXUI s wholly owned subsidiary banks, State Bank, GNB Financial, n.a., Gateway National Bank and Northwest Bank, was merged into the Bank. The Company issued approximately 10.8 million shares of its common stock for all of the issued and outstanding capital stock of TXUI. In addition, options to acquire 179,956 shares of TXUI common stock were converted into options to acquire 179,956 shares of Company common stock. In connection with the acquisition, the Company assumed $44.8 million in junior subordinated debentures issued to five subsidiary trusts. TXUI was publicly traded and operated forty-one (41) banking offices in Texas, two of which were subsequently consolidated with existing Prosperity banking centers. As of December 31, 2006, TXUI had, on a consolidated basis, total assets of $1.806 billion, loans (including loans held for sale) of $1.212 billion, deposits of $1.362 billion and shareholders equity of $161.9 million.

On August 31, 2007, the Company completed its acquisition of The Bank of Navasota, N.A., Navasota, Texas through the merger of the Bank of Navasota into the Bank. The Company issued approximately 251,000 shares of its common stock and paid approximately $8.6 million in cash for all of the issued and outstanding capital stock of the Bank of Navasota. The Bank of Navasota operated one banking office in Navasota, Texas, which became a full-service banking center of the Bank. As of June 30, 2007, the Bank of Navasota had total assets of $73.4 million, loans of $33.0 million, deposits of $63.8 million and shareholders equity of $9.1 million.

PENDING ACQUISITION

On October 22, 2007, the Company announced its signing of a definitive agreement by the Bank to purchase the six (6) Houston retail bank branches of Banco Popular North America (BPNA). The Bank will pay a premium of 10.10% on the average deposits of the branches for a 20-day period prior to the closing date and will also purchase certain loans and other assets attributable to the branches. As of September 30, 2007, there were $140 million in deposits in BPNA s Houston branches.

OVERVIEW

The Company, a Texas corporation, was formed in 1983 as a vehicle to acquire the former Allied First Bank in Edna, Texas which was chartered in 1949 as The First National Bank of Edna. The Company is a registered financial holding company that derives substantially all of its revenues and income from the operation of its bank subsidiary, Prosperity Bank® ( Prosperity Bank® or the Bank ). The Bank provides a wide array of financial products and services to small and medium-sized businesses and consumers. At September 30, 2007, the Bank operated one hundred twenty-four (124) full-service banking locations in Texas; with forty (40) in the Greater Houston Consolidated Metropolitan Statistical Area ( CMSA ), thirty-three (33) in the south Texas area including Corpus Christi and Victoria, twenty-seven (27) in the Dallas/Fort Worth area, two (2) in East Texas, twenty-two (22) in the Central Texas area including Austin and Bryan/College Station and one (1) loan production office in San Antonio. The Greater Houston CMSA includes Austin, Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, San Jacinto and Waller counties. The Company s headquarters are located at Prosperity Bank Plaza, 4295 San Felipe in Houston, Texas and its telephone number is (713) 693-9300. The Company s website address is www.prosperitybanktx.com. Information contained on the Company s website is not incorporated by reference into this quarterly report on Form 10-Q and is not part of this or any other report.

The Company generates the majority of its revenues from interest income on loans, service charges on customer accounts and income from investment in securities. The revenues are partially offset by interest expense paid on deposits and other borrowings and non-interest expenses such as administrative and occupancy expenses. Net interest income is the difference between interest income on earning assets such as loans and securities and interest expense on liabilities such as deposits and borrowings which are used to fund those assets. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and margin. The Company has recognized increased net interest income primarily due to an increase in the volume of interest-earning assets.

Three principal components of the Company s growth strategy are internal growth, stringent cost control practices and strategic merger transactions. The Company focuses on continual internal growth. Each banking center is operated as a separate profit center, maintaining separate data with respect to its net interest income, efficiency ratio, deposit growth, loan

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growth and overall profitability. Banking center presidents and managers are accountable for performance in these areas and compensated accordingly. The Company also focuses on maintaining stringent cost control practices and policies. The Company has invested significantly in the infrastructure required to centralize many of its critical operations, such as data processing and loan application processing. Management believes that this centralized infrastructure can accommodate substantial additional growth while enabling the Company to minimize operational costs through certain economies of scale. The Company also intends to continue to seek expansion opportunities. On April 1, 2006, the Company acquired SNB Bancshares, Inc. (the SNB acquisition ) which added six (6) banking centers. On January 31, 2007, the Company acquired TXUI which added thirty-nine (39) banking centers after two locations were consolidated with existing Prosperity banking centers and on August 31, 2007, the Company acquired the Bank of Navasota which added one banking center.

Total assets were $6.17 billion at September 30, 2007 compared with $4.59 billion at December 31, 2006, an increase of $1.58 billion or 34.5%. Total loans were $3.13 billion at September 30, 2007 compared with $2.18 billion at December 31, 2006, an increase of $951.0 million or 43.7%. Total deposits were $4.78 billion at September 30, 2007 compared with $3.73 billion December 31, 2006, an increase of $1.06 billion or 28.4%. Shareholders equity increased $446.8 million or 67.3%, to $1.11 billion at September 30, 2007 compared with $664.4 million at December 31, 2006. The increases were primarily due to the TXUI and Bank of Navasota acquisitions.

CRITICAL ACCOUNTING POLICIES

The Company s accounting policies are integral to understanding the financial results reported. Accounting policies are described in detail in Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. The Company believes that of its significant accounting policies, the following may involve a higher degree of judgment and complexity:

*Allowance for Credit Losses* The allowance for credit losses is established through charges to earnings in the form of a provision for credit losses. Management has established an allowance for credit losses which it believes is adequate for estimated losses in the Company s loan portfolio. Based on an evaluation of the loan portfolio, management presents a monthly review of the allowance for credit losses to the Bank s Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers factors such as historical loan loss experience, industry diversification of the Company s commercial loan portfolio, the amount of nonperforming assets and related collateral, the volume, growth and composition of the Company s loan portfolio, current economic changes that may affect the borrower s ability to pay and the value of collateral, the evaluation of the Company s loan portfolio through its internal loan review process and other relevant factors. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management s judgment, should be charged off. Charge-offs occur when loans are deemed to be uncollectible. The allowance for credit losses includes allowance allocations calculated in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by SFAS 118, and allowance allocations determined in accordance with SFAS No. 5, *Accounting for Contingencies*.

*Goodwill* Goodwill and intangible assets that have indefinite useful lives are subject to an annual impairment test and more frequently if circumstances indicate their value may not be recoverable. Goodwill is tested for impairment using a two-step process that begins with an estimation of the fair value of each of the Company s reporting units compared with its carrying value. If the carrying amount exceeds the fair value of a reporting unit, a second test is conducted comparing the implied fair value of the reporting unit s goodwill to its carrying value to measure the amount of impairment. Intangible assets that are not amortized will be tested for impairment at least annually by comparing the fair values of those assets to their carrying values. Other identifiable intangible assets that are subject to amortization are amortized on an accelerated basis over the years expected to be benefited, which the Company believes is between eight and ten years. These amortizable intangible assets are reviewed for impairment if circumstances indicate their value may not be recoverable based on a comparison of fair value to carrying value. Based on the Company s annual goodwill impairment test as of September 30, 2007, management does not believe any of its goodwill is impaired as of September 30, 2007. While the Company believes no impairment existed at September 30, 2007 under accounting standards applicable at that date, different conditions or assumptions, or changes in cash flows or profitability, if significantly negative or unfavorable, could have a material adverse effect on the outcome of the Company s impairment evaluation and financial condition or future results of operations.

*Stock-Based Compensation* The Company adopted the provisions of SFAS No. 123R *Share-Based Payment (Revised 2004)*, on January 1, 2006 and its adoption did not have a material impact on the Company s financial statements. The Company had previously adopted SFAS No. 123 on January 1, 2003. Among other things, SFAS No. 123R eliminates the ability to account for stock-based compensation using the intrinsic value based method of accounting and requires that such transactions be recognized as compensation expense in the income statement based on their fair values on the date of the grant.

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SFAS No. 123R requires that management make assumptions including stock price volatility and employee turnover that are utilized to measure compensation expense. The fair value of stock options granted is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions.

*Valuation of Securities*  The Company s available for sale securities portfolio is reported at fair value. When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair market value is below amortized cost, additional analysis is performed to determine whether an impairment exists. Available for sale and held to maturity securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers the (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company s results of operations and financial condition.

RESULTS OF OPERATIONS

Net income available to common shareholders was $23.8 million ($0.54 per common share on a diluted basis) for the quarter ended September 30, 2007 compared with $16.4 million ($0.49 per common share on a diluted basis) for the quarter ended September 30, 2006, an increase in net income of $7.5 million, or 45.7%. The Company posted returns on average common equity of 8.67% and 10.17%, returns on average assets of 1.53% and 1.46% and efficiency ratios of 46.41% and 44.31% for the quarters ended September 30, 2007 and 2006, respectively. The efficiency ratio is calculated by dividing total non-interest expense (excluding credit loss provisions) by net interest income plus non-interest income (excluding net gains and losses on the sale of securities and on the sale assets). Additionally, taxes are not part of this calculation.

For the nine months ended September 30, 2007, net income available to common shareholders was $67.1 million ($1.56 per common share on a diluted basis) compared with $45.1 million ($1.43 per common share on a diluted basis) for the same period in 2006, an increase in net income of $21.9 million or 48.6%. The Company posted returns on average common equity of 8.62% and 10.32%, returns on average assets of 1.47% and 1.43% and efficiency ratios of 46.58% and 46.08% for the nine months ended September 30, 2007 and 2006, respectively.

*Net Interest Income*

The Company s net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as a  volume change.  It is also affected by changes in yields earned on interest-earning assets and rates paid on interest-bearing deposits and other borrowed funds, referred to as a  rate change.

Net interest income on a tax equivalent basis was $52.2 million for the quarter ended September 30, 2007 compared with $36.5 million for the quarter ended September 30, 2006, an increase of $15.7 million, or 43.1%. Net interest income increased as a result of an increase in average interest-earning assets to $5.09 billion for the quarter ended September 30, 2007 compared with $3.83 billion for the quarter ended September 30, 2006, an increase of $1.25 billion, or 32.7%. The increase in average interest-earning assets is primarily attributable to increases in average loans and securities in the quarter ended September 30, 2007 compared with the quarter ended September 30, 2006 resulting from the TXUI and Bank of Navasota acquisitions.

The net interest margin on a tax equivalent basis increased to 4.07% for the quarter ended September 30, 2007 compared with 3.77% for the quarter ended September 30, 2006. The average rate paid on interest-bearing liabilities increased 26 basis points from 3.47% for the quarter ended September 30, 2006 compared with 3.73% for the quarter ended September 30, 2007, while the average yield on earning assets increased 43 basis points from 6.43% for the quarter ended September 30, 2006 compared with 6.86% for the quarter ended September 30, 2007. Average interest-bearing liabilities increased $906.3 million and average interest-earning assets increased $1.25 billion for the same periods.

Net interest income on a tax equivalent basis increased $48.0 million, or 46.6%, to $151.1 million for the nine months ended September 30, 2007 compared with $103.1 million for the same period in 2006. This increase is mainly attributable to higher average interest-earning assets resulting from an increase in average loans and securities due to the TXUI and Bank of Navasota acquisitions. The net interest margin on a tax equivalent basis for the nine months ended September 30, 2006 increased 23 basis points to 4.04% compared with 3.81% for the same period in 2006. The average rate paid on interest-bearing liabilities increased 49 basis points from 3.18% for the nine months ended September 30, 2006 compared with 3.67% for the same period in 2007 and the average yield on earning assets increased 59 basis points from 6.23% for the nine months ended September 30, 2006 compared with 6.82% for the nine months ended September 30, 2007.

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The following tables set forth, for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest earned or paid on such amounts, and the average rate earned or paid for the quarters ended September 30, 2007 and 2006 and the nine months ended September 30, 2007 and 2006. The tables also set forth the average rate paid on total interest-bearing liabilities, and the net interest margin on average total interest-earning assets for the same periods. Except as indicated in the footnotes, no tax-equivalent adjustments were made and all average balances are daily average balances. Any nonaccruing loans have been included in the table as loans carrying a zero yield.

| | Three Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2007 | | | 2006 | | |
| | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate (4) | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate (4) |
| | (Dollars in thousands) | | | | | |
| **Assets** | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans | $ 3,143,076 | $ 64,036 | 8.08% | $ 2,211,306 | $ 43,625 | 7.83% |
| Securities (1) | 1,892,030 | 23,316 | 4.93 | 1,605,597 | 18,302 | 4.56 |
| Federal funds sold and other temporary investments | 51,880 | 652 | 4.99 | 16,488 | 223 | 5.37 |
| Total interest-earning assets | 5,086,986 | 88,004 | 6.86% | 3,833,391 | 62,150 | 6.43% |
| Less allowance for credit losses | (35,862) | | | (24,228) | | |
| Total interest-earning assets, net of allowance | 5,051,124 | | | 3,809,163 | | |
| Noninterest-earning assets | 1,182,150 | | | 668,095 | | |
| Total assets | $ 6,233,274 | | | $ 4,477,258 | | |
| **Liabilities and shareholders equity** | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | $ 795,016 | $ 3,880 | 1.94% | $ 618,606 | $ 3,252 | 2.09% |
| Savings and money market accounts | 1,214,542 | 9,503 | 3.10 | 942,692 | 6,832 | 2.88 |
| Certificates of deposit | 1,567,848 | 18,411 | 4.66 | 1,202,038 | 12,435 | 4.10 |
| Junior subordinated debentures | 119,328 | 2,358 | 7.84 | 100,519 | 2,106 | 8.31 |
| Securities sold under repurchase agreements | 82,973 | 935 | 4.47 | 44,733 | 497 | 4.41 |
| Federal funds purchased and other borrowings | 116,609 | 1,548 | 5.27 | 81,415 | 1,061 | 5.17 |
| Total interest-bearing liabilities | 3,896,316 | 36,635 | 3.73% | 2,990,003 | 26,183 | 3.47% |
| Noninterest-bearing liabilities: | | | | | | |
| Noninterest-bearing demand deposits | 1,170,352 | | | 806,110 | | |
| Other liabilities | 66,678 | | | 37,661 | | |
| Total liabilities | 5,133,346 | | | 3,833,774 | | |
| Shareholders equity | 1,099,928 | | | 643,484 | | |
| Total liabilities and shareholders equity | $ 6,233,274 | | | $ 4,477,258 | | |
| Net interest rate spread | | | 3.13% | | | 2.96% |
| Net interest income and margin (2) | | $ 51,369 | 4.01% | | $ 35,967 | 3.72% |
| Net interest income and margin (tax-equivalent basis) (3) | | $ 52,182 | 4.07% | | $ 36,469 | 3.77% |

(1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.

(2) The net interest margin is equal to net interest income divided by average interest-earning assets.

(3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35%.

(4) Annualized. Average yield and average rate are calculated on an actual/365 day basis except for the average yield on securities which is calculated on a 30/360 day basis.

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| | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2007 | | | 2006 | | |
| | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate (4) | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate (4) |
| | (Dollars in thousands) | | | | | |
| **Assets** | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans | $ 3,078,065 | $ 185,919 | 8.08% | $ 1,981,411 | $ 113,685 | 7.67% |
| Securities (1) | 1,865,847 | 67,021 | 4.79 | 1,624,270 | 54,598 | 4.48 |
| Federal funds sold and other temporary investments | 58,117 | 2,228 | 5.13 | 15,185 | 563 | 4.96 |
| Total interest-earning assets | 5,002,029 | 255,168 | 6.82% | 3,620,866 | 168,846 | 6.23% |
| Less allowance for credit losses | (34,742) | | | (21,951) | | |
| Total interest-earning assets, net of allowance | 4,967,287 | | | 3,598,915 | | |
| Noninterest-earning assets | 1,119,480 | | | 610,038 | | |
| Total assets | $ 6,086,767 | | | $ 4,208,953 | | |
| **Liabilities and shareholders equity** | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | $ 830,770 | $ 12,803 | 2.06% | $ 588,097 | $ 7,950 | 1.81% |
| Savings and money market accounts | 1,211,118 | 26,800 | 2.96 | 866,724 | 16,391 | 2.53 |
| Certificates of deposit | 1,536,277 | 52,725 | 4.59 | 1,160,893 | 33,146 | 3.82 |
| Junior subordinated debentures | 128,522 | 7,852 | 8.17 | 89,522 | 5,497 | 8.21 |
| Securities sold under repurchase agreements | 72,724 | 2,319 | 4.26 | 44,857 | 1,292 | 3.85 |
| Federal funds purchased and other borrowings | 97,757 | 3,867 | 5.29 | 75,174 | 2,831 | 5.04 |
| Total interest-bearing liabilities | 3,877,168 | 106,366 | 3.67% | 2,825,267 | 67,107 | 3.18% |
| Noninterest-bearing liabilities: | | | | | | |
| Noninterest-bearing demand deposits | 1,123,452 | | | 769,021 | | |
| Other liabilities | 48,678 | | | 31,563 | | |
| Total liabilities | 5,049,298 | | | 3,625,851 | | |
| Shareholders equity | 1,037,469 | | | 583,102 | | |
| Total liabilities and shareholders equity | $ 6,086,767 | | | $ 4,208,953 | | |
| Net interest rate spread | | | 3.15% | | | 3.05% |
| Net interest income and margin (2) | | $ 148,802 | 3.98% | | $ 101,739 | 3.76% |
| Net interest income and margin (tax-equivalent basis) (3) | | $ 151,088 | 4.04% | | $ 103,070 | 3.81% |

(1) Yield is based on amortized cost and does not include any component of unrealized gains or losses.

(2) The net interest margin is equal to net interest income divided by average interest-earning assets.

(3) In order to make pretax income and resultant yields on tax-exempt investments and loans comparable to those on taxable investments and loans, a tax-equivalent adjustment has been computed using a federal income tax rate of 35%.

(4) Annualized. Average yield and average rate are calculated on an actual/365 day basis except for the average yield on securities which is calculated on a 30/360 day basis.

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The following tables present the dollar amount of changes in interest income and interest expense for the major components of interest-earning assets and interest-bearing liabilities and distinguish between the increase (decrease) related to outstanding balances and the volatility of interest rates. For purposes of these tables, changes attributable to both rate and volume which cannot be segregated have been allocated to rate.

| | Three Months Ended September 30, 2007 vs. 2006 Increase (Decrease) Due to | | |
|---|---|---|---|
| | Volume | Rate | Total |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Loans | $ 18,382 | $ 2,029 | $ 20,411 |
| Securities | 3,265 | 1,749 | 5,014 |
| Federal funds sold and other temporary investments | 479 | (50) | 429 |
| Total increase in interest income | 22,126 | 3,728 | 25,854 |
| Interest-bearing liabilities: | | | |
| Interest-bearing demand deposits | 927 | (299) | 628 |
| Savings and money market accounts | 1,970 | 701 | 2,671 |
| Certificates of deposit | 3,784 | 2,192 | 5,976 |
| Junior subordinated debentures | 394 | (142) | 252 |
| Securities sold under repurchase agreements | 425 | 13 | 438 |
| Federal funds purchased and other borrowings | 459 | 28 | 487 |
| Total increase in interest expense | 7,959 | 2,493 | 10,452 |
| Increase in net interest income | $ 14,167 | $ 1,235 | $ 15,402 |

| | Nine Months Ended September 30, 2007 vs. 2006 Increase (Decrease) Due to | | |
|---|---|---|---|
| | Volume | Rate | Total |
| | (Dollars in thousands) | | |
| Interest-earning assets: | | | |
| Loans | $ 62,921 | $ 9,313 | $ 72,234 |
| Securities | 8,120 | 4,303 | 12,423 |
| Federal funds sold and other temporary investments | 1,592 | 73 | 1,665 |
| Total increase in interest income | 72,633 | 13,689 | 86,322 |
| Interest-bearing liabilities: | | | |
| Interest-bearing demand deposits | 3,280 | 1,573 | 4,853 |
| Savings and money market accounts | 6,513 | 3,896 | 10,409 |
| Certificates of deposit | 10,718 | 8,861 | 19,579 |
| Junior subordinated debentures | 2,395 | (40) | 2,355 |
| Securities sold under repurchase agreements | 803 | 224 | 1,027 |
| Federal funds purchased and other borrowings | 900 | 136 | 1,036 |

| | | | |
|---|---|---|---|
| Total increase in interest expense | 24,609 | 14,650 | 39,259 |
| Increase (decrease) in net interest income | $ 48,024 | $ (961) | $ 47,063 |

*Provision for Credit Losses*

Management actively monitors the Company s asset quality and provides specific loss provisions when necessary. Provisions for credit losses are charged to income to bring the total allowance for credit losses to a level deemed appropriate by management of the Company based on such factors as historical credit loss experience, industry diversification of the commercial loan portfolio, the amount of nonperforming loans and related collateral, the volume growth and composition of the loan portfolio, current economic conditions that may affect the borrower s ability to pay and the value of collateral, the evaluation of the loan portfolio through the internal loan review function and other relevant factors.

Loans are charged-off against the allowance for credit losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the provision for credit losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

The Company made a $75,000 provision for credit losses for the quarter ended September 30, 2007 and a $120,000 provision for the quarter ended September 30, 2006. The Company made a $640,000 provision for credit losses for the nine months ended September 30, 2007 and a $360,000 provision for the quarter ended September 30, 2006. The ratio of the allowance for credit losses to end of period nonperforming loans was 448.8% for the nine months ended September 30, 2007 compared with 2,530.6% for the year ended December 31, 2006. The ratio of allowance for credit losses to total loans was 1.14% at September 30, 2007 compared with 1.10% at December 31, 2006. For the quarter ended September 30, 2007, net charge-offs were $1.3 million compared with net charge-offs of $307,000 for the quarter ended September 30, 2006. Net charge-offs were $2.5 million for the nine months ended September 30, 2007 compared with $524,000 for the nine months ended September 30, 2006.

*Noninterest Income*

The Company s primary sources of noninterest income are service charges on deposit accounts, which includes insufficient funds charges and other banking-related service fees. Noninterest income does not include loan origination fees which are recognized over the life of the related loan as an adjustment to yield using the interest method. Banking-related service fees include check cashing fees, official check fees, safe deposit box rent and currency handling fees. Noninterest income totaled $14.2 million for the three months ended September 30, 2007 compared with $8.9 million for the same period in 2006, an increase of $5.2 million, or 58.8%. Noninterest income increased $13.9 million, or 54.1%, to $39.7 million for the nine months ended September 30, 2007 compared with $25.7 million for the same period in 2006. The increases during both periods were primarily due to an increase in insufficient funds charges and customer service charges which mainly resulted from an increase in the number of accounts due to the TXUI and Bank of Navasota acquisitions. At September 30, 2007, the two acquisitions added approximately 79,000 deposit accounts and over 34,000 debit cards.

Income from bank owned life insurance increased $382,000 from $122,000 for the quarter ended September 30, 2006 to $504,000 for the quarter ended September 30, 2007 and increased $1.0 million from $372,000 for the nine months ended September 30, 2006 to $1.4 million for the nine months ended September 30, 2007. The increases in both periods were primarily due to the additional bank owned life insurance acquired in the TXUI acquisition.

The net gain on sale of held for sale loans was $269,000 for the three months ended September 30, 2007 compared with no activity for the three months ended September 30, 2006. The net gain on sale of held for sale loans was $1.2 million for the nine months ended September 30, 2007 compared with no activity for the same period in 2006. The Company acquired a mortgage operations division in the TXUI acquisition that originated mortgage loans for sale into the secondary market. Beginning in the fourth quarter of 2007, the Company ceased originating mortgage loans for sale into the secondary market. The Company will continue to recognize gains and losses in future periods on loans originated prior to September 30, 2007.

The net gain on sale of assets was $639,000 for the three months ended September 30, 2007 compared with $132,000 for the three months ended September 30, 2006. The net gain on sale of assets was $735,000 for the nine months ended September 30, 2007 compared with $578,000 for the same period in 2006. The increases were primarily due to gains on the sale of ORE.

The following table presents, for the periods indicated, the major categories of noninterest income:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands) | | | |
| Service charges on deposit accounts | $ 10,785 | $ 7,079 | $ 29,908 | $ 20,610 |
| Banking-related service fees | 445 | 353 | 1,287 | 998 |
| Brokered mortgage income | 188 | 233 | 574 | 661 |
| Investment income | 170 | 45 | 1,146 | 158 |
| Income from leased assets | 353 | 269 | 980 | 806 |
| Bank owned life insurance income (BOLI) | 504 | 122 | 1,402 | 372 |
| Net gain on sale of assets | 639 | 132 | 735 | 578 |

| | | | | |
|---|---|---|---|---|
| Net gain on sale of securities | 58 | | 58 | |
| Net gain on sale of held for sale loans | 269 | | 1,202 | |
| Other noninterest income | 748 | 685 | 2,383 | 1,558 |
| Total noninterest income | $ 14,159 | $ 8,918 | $ 39,675 | $ 25,741 |

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*Noninterest Expense*

Noninterest expense totaled $30.1 million for the quarter ended September 30, 2007 compared with $19.8 million for the quarter ended September 30, 2006, an increase of $10.3 million, or 51.7%. This increase occurred primarily in salaries and employee benefits, core deposit intangibles amortization, depreciation and occupancy and equipment expense. Noninterest expense totaled $87.4 million for the nine months ended September 30, 2007 compared with $58.5 million for the nine months ended September 30, 2006, an increase of $29.0 million, or 49.5%. The increases during both periods were primarily due to the TXUI and Bank of Navasota acquisitions. The following table presents, for the periods indicated, the major categories of noninterest expense:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands) | | | |
| Salaries and employee benefits (1) | $ 16,365 | $ 10,268 | $ 48,163 | $ 31,195 |
| Non-staff expenses: | | | | |
| Occupancy and equipment expense | 2,665 | 2,166 | 7,759 | 5,814 |
| Depreciation | 1,895 | 1,265 | 5,656 | 3,767 |
| Data processing | 1,290 | 928 | 3,447 | 2,728 |
| Communications expense | 1,665 | 1,107 | 4,639 | 3,268 |
| Professional fees | 408 | 345 | 1,244 | 1,044 |
| Regulatory assessments and FDIC insurance | 218 | 201 | 756 | 532 |
| Ad valorem and franchise taxes | 689 | 554 | 1,974 | 1,625 |
| Core deposit intangibles amortization | 2,586 | 1,191 | 7,297 | 3,616 |
| Other | 2,306 | 1,804 | 6,495 | 4,888 |
| Total non-staff expenses | 13,722 | 9,561 | 39,267 | 27,282 |
| Total noninterest expense | $ 30,087 | $ 19,829 | $ 87,430 | $ 58,477 |

(1) Includes stock based compensation expense of $534 and $223 for the three months ended September 30, 2007 and 2006, respectively, and $1,491 and $606 for the nine months ended September 30, 2007 and 2006, respectively.

Salaries and employee benefit expenses were $16.4 million for the quarter ended September 30, 2007 compared with $10.3 million for the quarter ended September 30, 2006, an increase of $6.1 million, or 59.4%. For the nine months ended September 30, 2007, salaries and employee benefit expenses were $48.2 million, an increase of $17.0 million or 54.4% compared with $31.2 million for the nine months ended September 30, 2006. The increases during both periods were principally due to additional staff associated with the TXUI and Bank of Navasota acquisitions and routine annual salary increases. The number of full-time equivalent (FTE) associates employed by the Company increased from 914 at September 30, 2006 to 1,369 at September 30, 2007.

Non-staff expenses increased $4.2 million, or 43.5%, to $13.7 million for the quarter ended September 30, 2007 compared with $9.6 million during the same period in 2006. Non-staff expenses increased $12.0 million, or 43.9%, to $39.3 million for the nine months ended September 30, 2007 compared to $27.3 million during the same period in 2006. The increases during both periods were principally due to additional expenses associated with TXUI and Bank of Navasota acquisitions, increases in core deposit intangibles amortization related to the 2006 and 2007 acquisitions and increases in occupancy and equipment expense due to the additional banking centers acquired in 2006 and 2007.

*Income Taxes*

Income tax expense increased $2.9 million, or 34.4%, to $11.5 million for the quarter ended September 30, 2007 compared with $8.6 million for the same period in 2006. For the nine months ended September 30, 2007, income tax expense totaled $33.3 million, an increase of $9.8 million or 41.7% compared with $23.5 million for the same period in 2006. Both increases were primarily attributable to higher pretax net earnings for the quarter and nine months ended September 30, 2007 when compared to the same periods in 2006. The effective tax rates for the three months ended September 30, 2007 and 2006 and the nine months ended September 30, 2007 and 2006 were 32.6%, 34.4%, 33.2% and 34.3%,

respectively.

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*Loan Portfolio*

Total loans were $3.13 billion at September 30, 2007, an increase of $951.0 million or 43.7% compared with $2.18 billion at December 31, 2006. The increase was due to loans acquired in the TXUI and Bank of Navasota acquisitions. At September 30, 2007, total loans outstanding acquired from TXUI totaled $989.7 million and total loans acquired from Bank of Navasota totaled $30.8 million. Period end loans comprised 61.5% of average earning assets for the quarter ended September 30, 2007 compared with 56.3% of average earning assets for the quarter ended December 31, 2006.

The following table summarizes the loan portfolio of the Company by type of loan as of September 30, 2007 and December 31, 2006:

| | September 30, 2007 | | December 31, 2006 | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Commercial and industrial | $ 427,094 | 13.7% | $ 280,957 | 12.9% |
| Real estate: | | | | |
| Construction and land development | 708,355 | 22.6 | 433,178 | 19.9 |
| 1-4 family residential | 527,175 | 16.9 | 376,996 | 17.3 |
| Home equity | 94,861 | 3.0 | 63,427 | 2.9 |
| Commercial mortgages | 1,029,969 | 32.9 | 803,145 | 36.9 |
| Farmland | 58,889 | 1.9 | 30,925 | 1.4 |
| Multifamily residential | 78,285 | 2.5 | 77,980 | 3.6 |
| Agriculture | 56,730 | 1.8 | 26,504 | 1.2 |
| Other | 18,038 | 0.6 | 66,675 | 3.1 |
| Consumer (net of unearned discount) | 128,159 | 4.1 | 16,720 | 0.8 |
| Total loans | $ 3,127,555 | 100.0% | $ 2,176,507 | 100.0% |

*Nonperforming Assets*

The Company had $9.5 million in nonperforming assets at September 30, 2007 and $1.1 million in nonperforming assets at December 31, 2006, an increase of $8.4 million or 748.1%. The nonperforming assets at September 30, 2007 consisted of seventy-five (75) separate credits or ORE properties. Of the $8.4 million increase from December 31, 2006 to September 30, 2007, $835,000 was attributable to one ORE property and an additional $4.3 million was attributable to three accruing loans 90 or more days past due. The ORE property was under contract to be sold at September 30, 2007 and the sale was consummated in October 2007. Of the $4.3 million accruing loans 90 or more days past due, $2.2 million was scheduled to be paid off or otherwise resolved in October 2007. The ratio of nonperforming assets to loans and other real estate was 0.30% at September 30, 2007 compared with 0.05% at December 31, 2006.

The Company generally places a loan on nonaccrual status and ceases accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases if the collection of the principal is deemed unlikely, unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan. The Company generally charges off all loans before attaining nonaccrual status.

The following table presents information regarding nonperforming assets as of the dates indicated:

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| Nonaccrual loans | $ 1,645 | $ 181 |

| | | |
|---|---|---|
| Restructured loans | | |
| Accruing loans 90 or more days past due | 6,273 | 767 |
| Total nonperforming loans | 7,918 | 948 |
| Repossessed assets | 121 | 32 |
| Other real estate | 1,460 | 140 |
| Total nonperforming assets | $ 9,499 | $ 1,120 |
| Nonperforming assets to total loans and other real estate | 0.30% | 0.05% |

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*Allowance for Credit Losses*

Management actively monitors the Company s asset quality and provides specific loss allowances when necessary. Loans are charged-off against the allowance for credit losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the allowance for credit losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations. As of September 30, 2007, the allowance for credit losses amounted to $35.5 million, or 1.14% of total loans, compared with $24.0 million, or 1.10% of total loans at December 31, 2006.

Set forth below is an analysis of the allowance for credit losses for the nine months ended September 30, 2007 and the year ended December 31, 2006:

| | As of and for the Nine Months Ended September 30, 2007 | As of and for the Year Ended December 31, 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| Average loans outstanding | $ 3,078,065 | $ 2,037,379 |
| Gross loans outstanding at end of period | $ 3,127,555 | $ 2,176,507 |
| Allowance for credit losses at beginning of period | $ 23,990 | $ 17,203 |
| Balance acquired with acquisitions | 13,386 | 7,054 |
| Provision for credit losses | 640 | 504 |
| Charge-offs: | | |
| Commercial and industrial | (686) | (353) |
| Real estate and agriculture | (903) | (128) |
| Consumer | (2,324) | (696) |
| Recoveries: | | |
| Commercial and industrial | 322 | 95 |
| Real estate and agriculture | 158 | 59 |
| Consumer | 953 | 252 |
| Net charge-offs | (2,480) | (771) |
| Allowance for credit losses at end of period | $ 35,536 | $ 23,990 |
| Ratio of allowance to end of period loans | 1.14% | 1.10% |
| Ratio of net charge-offs to average loans | 0.08% | 0.04% |
| Ratio of allowance to end of period nonperforming loans | 448.8% | 2,530.6% |

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*Securities*

The amortized cost of securities totaled $1.81 billion at September 30, 2007 compared with $1.59 billion at December 31, 2006. The increase was principally due to securities acquired in the TXUI acquisition. At September 30, 2007, securities represented 29.2% of total assets compared with 34.7% of total assets at December 31, 2006.

The following table summarizes the amortized cost of securities as of the dates shown (available-for-sale securities are not adjusted for unrealized gains or losses):

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| U.S. Treasury securities and obligations of U.S. government agencies | $ 328,477 | $ 402,328 |
| 70% nontaxable preferred stock | 24,000 | 24,000 |
| States and political subdivisions | 88,521 | 44,378 |
| Corporate debt securities | 3,214 | 6,218 |
| Collateralized mortgage obligations | 234,056 | 276,629 |
| Mortgage-backed securities | 1,113,764 | 829,195 |
| Qualified Zone Academy Bond (QZAB) | 8,000 | 8,000 |
| Equity securities | 7,217 | 4,093 |
| Total amortized cost | $ 1,807,249 | $ 1,594,841 |
| Total fair value | $ 1,794,690 | $ 1,565,427 |

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any recovery of cost.

Management has the ability and intent to hold the securities classified as held to maturity until they mature, at which time the Company will receive full value for the securities. Furthermore, management also has the ability and intent to hold the securities classified as available for sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2007, management believes any impairment in the Company s securities are temporary and no impairment loss has been realized in the Company s consolidated income statement.

*Bank Premises and Equipment*

Premises and equipment, net of accumulated depreciation, totaled $120.8 million and $63.1 million at September 30, 2007 and December 31, 2006, respectively, an increase of $57.7 million or 91.6%. The increase was primarily due to 40 banking centers acquired in the TXUI and Bank of Navasota acquisitions.

*Deposits*

Total deposits were $4.78 billion at September 30, 2007 compared with $3.73 billion at December 31, 2006, an increase of $1.06 billion or 28.4%. The increase was primarily due to deposits assumed in the TXUI and Bank of Navasota acquisitions. At September 30, 2007, deposits attributed to TXUI totaled $1.17 billion and deposits attributed to Bank of Navasota totaled $60.5 million. At September 30, 2007, noninterest-bearing deposits accounted for approximately 24.4% of total deposits compared with 22.4% of total deposits at December 31, 2006. Interest-bearing demand deposits totaled $3.62 billion or 75.6% of total deposits at September 30, 2007 compared with $2.89 billion or 77.6% of total deposits at December 31, 2006.

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The following table summarizes the daily average balances and weighted average rates paid on deposits for the periods presented below:

| | For the Nine Months Ended September 30, 2007 | | For the Year Ended December 31, 2006 | |
|---|---|---|---|---|
| | Amount | Rate | Amount | Rate |
| | (Dollars in thousands) | | | |
| Interest-bearing demand | $ 830,770 | 2.06% | $ 602,946 | 1.90% |
| Regular savings | 221,537 | 1.04 | 164,963 | 1.11 |
| Money market savings | 989,581 | 3.39 | 732,704 | 2.96 |
| Time deposits | 1,536,277 | 4.59 | 1,165,056 | 3.95 |
| Total interest-bearing deposits | 3,578,165 | 3.45 | 2,665,669 | 3.04 |
| Noninterest-bearing deposits | 1,123,452 | | 783,431 | |
| Total deposits | $ 4,701,617 | 2.63% | $ 3,449,100 | 2.35% |

*Other Borrowings*

The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. Borrowings consist of funds from the Federal Home Loan Bank ( FHLB ) and correspondent banks. FHLB borrowings consist of long-term notes payable and FHLB advances which are considered short-term, overnight borrowings. At September 30, 2007, the Company had $32.0 million in FHLB borrowings, all of which consisted of long-term FHLB notes payable compared with $26.4 million in FHLB borrowings at December 31, 2006, all of which consisted of long-term FHLB notes payable. The $5.6 million increase was primarily attributable to the assumption of additional long term notes payable in the TXUI acquisition. The maturity dates on the FHLB notes payable range from the years 2007 to 2027 and have interest rates ranging from 2.93% to 6.33%. The highest outstanding balance of FHLB advances during the nine months ended September 30, 2007 was $240.0 million compared with $116.0 million during the year ended December 31, 2006. The Company had no federal funds purchased at September 30, 2007 or December 31, 2006.

At September 30, 2007, the Company had $79.5 million in securities sold under repurchase agreements compared with $47.2 million at December 31, 2006, an increase of $32.3 million or 68.3%. The increase was primarily due to the TXUI acquisition.

The following table presents the Company s borrowings at September 30, 2007 and December 31, 2006:

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| FHLB advances | $ | $ |
| FHLB long-term notes payable | 31,988 | 26,408 |
| Total other borrowings | 31,988 | 26,408 |
| Federal funds purchased | | |
| Securities sold under repurchase agreements | 79,484 | 47,225 |
| Total | $ 111,472 | $ 73,633 |

*Junior Subordinated Debentures*

At September 30, 2007 and December 31, 2006, the Company had outstanding $112.9 million and $100.5 million, respectively, in junior subordinated debentures issued to the Company s unconsolidated subsidiary trusts. The increase of $12.4 million was due to the Company s

assumption on January 31, 2007 of $44.8 million in junior subordinated debentures issued by TXUI to its five subsidiary trusts, partially offset by the redemption of the debentures held by First Capital Statutory Trust I in the amount of $20.6 million on June 26, 2007, the redemption of the debentures held by Gateway Statutory Trust I in the amount of $4.1 million on June 26, 2007 and the redemption of the debentures held by First Capital Statutory Trust II in the amount $7.7 million on September 26, 2007. The debentures redeemed on June 26, 2007 bore interest at a floating rate of 3 month LIBOR + 3.60% and the debentures redeemed on September 26, 2007 bore interest at a floating rate of 3 month LIBOR + 3.40%. The trusts in turn redeemed in full the trust preferred securities and common securities they issued.

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A summary of pertinent information related to the Company s ten issues of junior subordinated debentures outstanding at September 30, 2007 is set forth in the table below:

| Description | Issuance Date | Trust Preferred Securities Outstanding | Interest Rate[1] | Junior Subordinated Debt Owed to Trusts | Maturity Date[2] |
|---|---|---|---|---|---|
| Prosperity Statutory Trust II | July 31, 2001 | $ 15,000,000 | 3-month LIBOR + 3.58%, not to exceed 12.50% | $ 15,464,000 | July 31, 2031 |
| Prosperity Statutory Trust III | Aug. 15, 2003 | 12,500,000 | 6.50%[3] | 12,887,000 | Sept. 17, 2033 |
| Prosperity Statutory Trust IV | Dec. 30, 2003 | 12,500,000 | 6.50%[4] | 12,887,000 | Dec. 30, 2033 |
| SNB Statutory Trust II[5] | Mar. 26, 2003 | 10,000,000 | 3-month LIBOR +3.15% | 10,310,000 | Mar. 26, 2033 |
| SNB Capital Trust III[5] | Mar. 27, 2003 | 10,000,000 | 3-month LIBOR +3.15% | 10,310,000 | Mar. 27, 2033 |
| SNB Capital Trust IV[5] | Sept. 25, 2003 | 10,000,000 | 3-month LIBOR +3.00% | 10,310,000 | Sept. 25, 2033 |
| TXUI Statutory Trust I[6] | Sept. 07, 2000 | 7,000,000 | 10.60% | 7,210,000 | Sept. 07, 2030 |
| TXUI Statutory Trust II[6] | Dec. 19, 2003 | 5,000,000 | 6.45% [7] | 5,155,000 | Dec. 19, 2033 |
| TXUI Statutory Trust III[6] | Nov. 30, 2005 | 15,500,000 | 3-month LIBOR +1.39% | 15,980,000 | Dec. 15, 2035 |
| TXUI Statutory Trust IV[6] | Mar. 31, 2006 | 12,000,000 | 3-month LIBOR + 1.39% | 12,372,000 | Jun. 30, 2036 |

(1) The 3-month LIBOR in effect as of September 30, 2007 was 5.23%.
(2) All debentures are callable five years from issuance date except for TXUI Statutory Trust I which is callable ten years from issuance date.
(3) The debentures bear a fixed interest rate until September 17, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 3.00%.
(4) The debentures bear a fixed interest rate until December 30, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.
(5) Assumed in connection with the SNB acquisition on April 1, 2006.
(6) Assumed in connection with the TXUI acquisition on January 31, 2007.
(7) The debentures bear a fixed interest rate until December 19, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.

*Liquidity*

Liquidity involves the Company s ability to raise funds to support asset growth or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate the Company on an ongoing basis. The Company s liquidity needs have primarily been met by growth in core deposits and the issuance of junior subordinated debentures. Although access to purchased funds from correspondent banks is available and has been utilized on occasion to take advantage of investment opportunities, the Company does not generally rely on these external funding sources. The cash and federal funds sold position, supplemented by amortizing investment and loan portfolios, have generally created an adequate liquidity position.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. As of September 30, 2007, the Company had cash and cash equivalents of $242.5 million compared with $269.7 million at December 31, 2006. The decrease of $27.2

million is related to a reduction in federal funds sold of $52.8 million, partially offset by an increase in cash and due from banks of $25.6 million primarily due to the TXUI and Navasota acquisitions.

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*Contractual Obligations*

The following table summarizes the Company s contractual obligations and other commitments to make future payments as of September 30, 2007 (other than deposit obligations). The Company s future cash payments associated with its contractual obligations pursuant to its junior subordinated debentures, FHLB notes payable and operating leases as of September 30, 2007 are summarized below. Payments for FHLB notes payable do not include interest of $8.5 million that will be paid over the future periods presented. Payments related to leases are based on actual payments specified in underlying contracts.

| | Payments due in: | | | | |
|---|---|---|---|---|---|
| | Remaining Fiscal 2007 | Fiscal 2008-2009 | Fiscal 2010-2011 | Thereafter | Total |
| | (Dollars in thousands) | | | | |
| Junior subordinated debentures | $ | $ | $ | $ 112,885 | $ 112,885 |
| Federal Home Loan Bank notes payable | 431 | 4,859 | 14,056 | 12,642 | 31,988 |
| Operating leases | 833 | 5,750 | 3,417 | 2,248 | 12,248 |
| Total | $ 1,264 | $ 10,609 | $ 17,473 | $ 127,775 | $ 157,121 |

*Off-Balance Sheet Items*

In the normal course of business, the Company enters into various transactions, which, in accordance with accounting principles generally accepted in the United States, are not included in its consolidated balance sheets. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company s commitments associated with outstanding standby letters of credit and commitments to extend credit as of September 30, 2007 are summarized below. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements.

| | Remaining Fiscal 2007 | Fiscal 2008-2009 | Fiscal 2010-2011 | Thereafter | Total |
|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | |
| Standby letters of credit | $ 3,558 | $ 10,524 | $ 163 | $ 857 | $ 15,102 |
| Commitments to extend credit | 185,147 | 420,273 | 10,139 | 110,454 | 726,013 |
| Total | $ 188,705 | $ 430,797 | $ 10,302 | $ 111,311 | $ 741,115 |

*Capital Resources*

Total shareholders equity was $1.11 billion at September 30, 2007 compared with $664.4 million at December 31, 2006, an increase of $446.8 million or 67.3%. The increase was due primarily to net earnings of $67.1 million, the issuance of common stock in connection with the TXUI and Bank of Navasota acquisitions of $389.4 million and the issuance of common stock in connection with the exercise of stock options of $2.7 million, partially offset by dividends paid of $14.8 million for the nine months ended September 30, 2007.

Both the Board of Governors of the Federal Reserve System with respect to the Company, and the Federal Deposit Insurance Corporation ( FDIC ) with respect to the Bank, have established certain minimum risk-based capital standards that apply to bank holding companies and federally insured banks. The following table sets forth the Company s total risk-based capital, Tier I risk-based capital, and Tier I to average assets (leverage) ratios as of September 30, 2007:

| Consolidated Capital Ratios: |
|---|

| | |
|---|---|
| Total capital (to risk weighted assets) | 14.11% |
| Tier I capital (to risk weighted assets) | 13.03% |
| Tier I capital (to average assets) | 7.83% |

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As of September 30, 2007, the Bank s risk-based capital ratios were above the levels required for the Bank to be designated as well capitalized by the FDIC. The following table sets forth the Bank s total risk-based capital, Tier I risk-based capital, and Tier I to average assets (leverage) capital ratios as of September 30, 2007:

| Capital Ratios (Bank Only): | |
|---|---|
| Total capital (to risk weighted assets) | 13.49% |
| Tier I capital (to risk weighted assets) | 12.40% |
| Tier I capital (to average assets) | 7.45% |

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company manages market risk, which for the Company is primarily interest rate risk, through its Asset Liability Committee which is composed of senior officers of the Company, in accordance with policies approved by the Company s Board of Directors.

The Company uses simulation analysis to examine the potential effects of market changes on net interest income and market value. The Company considers macroeconomic variables, Company strategy, liquidity and other factors as it quantifies market risk. See the Company s Annual Report on Form 10-K, Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations-Interest Rate Sensitivity and Liquidity which was filed on March 1, 2007 for further discussion.

ITEM 4. CONTROLS AND PROCEDURES

*Evaluation of disclosure controls and procedures.* As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act )) are effective.

*Changes in internal control over financial reporting*. On January 31, 2007, the Company completed the acquisition of TXUI and on August 31, 2007 the Company completed the acquisition of the Bank of Navasota. The Company is in the process of integrating the operations of TXUI and Bank of Navasota into its operations and continuing its evaluation of internal controls pursuant to the Sarbanes-Oxley Act of 2002. Excluding the TXUI and Bank of Navasota acquisitions, there have not been any changes in the Company s internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not Applicable

ITEM 1A. RISK FACTORS

There have been no material changes in the Company s risk factors from those disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

a. Not applicable
b. Not applicable

c. Not applicable

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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS

The following exhibits are filed or furnished with this Quarterly Report on Form 10-Q;

| Exhibit Number | Description of Exhibit |
|---|---|
| 3.1 | Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-1 (Registration No. 333-63267) (the Registration Statement )) |
| 3.2 | Articles of Amendment to Amended and Restated Articles of Incorporation of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.2 to the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2006) |
| 3.3 | Amended and Restated Bylaws of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K filed on October 19, 2007) |
| 4.1 | Form of certificate representing shares of the Company s common stock (incorporated by reference to Exhibit 4 to the Registration Statement) |
| 31.1* | Certification of the Chief Executive Officer pursuant to Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended |
| 31.2* | Certification of the Chief Financial Officer pursuant to Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended |
| 32.1** | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2** | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Filed with this Quarterly Report on Form 10-Q.
** Furnished with this Quarterly Report on Form 10-Q.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PROSPERITY BANCSHARES, INC.[SM]

(Registrant)

| | |
|---|---|
| Date: 11/09/07 | /s/ David Zalman<br>David Zalman<br>Chairman and Chief Executive Officer |
| Date: 11/09/07 | /s/ David Hollaway<br>David Hollaway<br>Chief Financial Officer |

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